


LAW REGULATION
keeping investments in or out of line
with the development of the IT sector

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Rising Of The It Sector In The Republic Of Serbia

In the last 15 years, the Serbian IT sector reached significant growth. From sole traders/entrepreneurs, agencies, to smaller companies that provide services through “outsourcing” to clients in Western Europe and North America, the IT sector has developed with service-related companies that export services worth over EUR 1.7 billion, with an annual growth of 30% and, globally successful companies developing complex technological products and operating in large worldwide markets.

By virtue of the programs for the accelerated development of the startup ecosystem and the orientation of service-related companies towards providing services with great added value, Serbia is in an excellent position to become a leader in this domain.

Companies had modest funds at their disposal when established, so outsourcing to Western Europe and North America was a logical path as the most profitable solution.

During the last 15 years, first gradual and then sudden transformation of the IT sector occurred, due to the expertise of people from high-quality technical faculties in Serbia, but also through informal education and excellent knowledge of the English language, which contributed to the easier cooperation and creation of additional value on the market.

Due to these reasons, the Serbian IT sector exported services with an excellent quality-price ratio.

Domestic IT services market reached a value of around EUR 300 million and is growing annually, while the export of IT services in 2021 amounted to EUR 1.73 billion, which is an annual growth of 30%. In 2016, Serbia was in 42nd place, and it is expected to reach 35th place in 2021, according to information from the World Trade Organization.

“Alternative” Investing In The It Sector

This growth trend is certainly recognized by the legislator with numerous tax incentives, primarily for innovative creators of products and services such as startups, as well as their necessary financial development.

The development itself, through the investment mechanism, among others, is established by the solutions of the Law on Alternative Investment Funds (AIF Law) which, among other things, regulates the establishment and management of alternative investment funds, as well as the incorporation, activity and operations of companies managing alternative investment funds.

AIF Law defines an alternative investment fund (AIF) as an investment fund that collects funds from investors with the intention of investing them in accordance with the established investment policy for the benefit of those investors, and for which a license is not required, in pursuant with the Law on Open-End Investment Funds subject to Public Offering.

Furthermore, AIF Law also defines the company for the management of alternative investment funds (AIF Company) as a legal entity registered in the Republic of Serbia whose regular activity is the management of one or more AIFs based on an approval license issued by the Securities Commission (Commission), in accordance with that law.

Commission maintains a public register for AIF and AIF Company. AIF Company is established as a limited liability company (LLC) or a joint-stock company (JSC), which is not a listed company in the sense of the law governing the capital market (exceptionally, it can also be established as a two-tier managed JSC).

This enables somewhat more flexible access to the market, considering that the incorporation and management of LLCs and non-listed JSCs is much easier whereas it is not subject to strict control by Commission.

Also, non-listed JSC does not have the obligation to submit a request for the inclusion of its equity securities in trading on the regulated market managed by the market organizer (stock exchange) nor it is, to full extent, subjected to provisions of the Capital Market Law (CML,) which apply to listed JSC. Therefore, with a non-listed JSC, no public offering and issuance of shares is required, no obligation to prepare a prospectus for the offer in accordance with CML, etc.

The provisions of the Company Law (Company Law) apply to AIF Company and the provisions of CML, unless the AIF Law prescribes otherwise, meaning that AIF Law exclusively regulates part of this ecosystem, which is a fertile ground for the development and progress of startups and technological businesses. However, LLC and JSC are in principle incorporated, managed, and operate in accordance with the Company Law considering the characteristics of these legal forms of companies.

AIF and AIF Company represent what is known in the financial world as “Venture Capital Funding” or “VC Funding”. In domestic area, such terms would be translated as “entrepreneurial capital” or

“risk capital”. However, this terminology does not reflect the purpose of this very method of financing, as it deters potential investors from startups (as a type of risky venture), which the Serbian market still perceives as an a priori unsafe investment, and therefore insufficiently regulated (or at least it used to be).

Nevertheless, it is a fact that in recent years this type of investment has been formalized to a greater extent, which gradually develops and achieves financial goals in the IT sector as a type of initial investment which is necessary for numerous technological startups and other business undertakings.

The new Law on Innovation Activities strives to somehow change that negative perception by defining these entities as investors in innovation activities who invest financial resources in startups, i.e., as the law symbolically designates them as “business angels”.

The initial investment is oftentimes insufficient for sustainable business development.

Each individual financing venture, when carried out by AIF Company managing AIFs and other investors, represents a comprehensive process based on various verification actions (Due Diligence) as well as on the functional cooperation of startups-applicants, investors and possibly engaged third parties if required for contemplated investment.

Due Diligence includes several main categories conducted with the support of experts from respective fields such as technical, financial, market, tax, and legal analysis.

The targeted issues within those categories are business and social reputation, skills/experts' team, investment timing, sales/marketing, product viability, intellectual property rights protection and preservation followed with other related legal issues, income-costs ration ("burn rate"), social impact, competition on relevant markets and Exit potential, i.e. an opportunity for the future sale and monetization.

For a rising startup or other investment-seeking entity to be brought to an end of this rather, comprehensive process,

experts from different respective fields are required always when the financial efficiency accompanied with law compliance is the goal of such undertakings.

Tax Incentives

In addition to the created ecosystem where investing entities (AIF, AIF Company) operate, legislation in the Republic of Serbia also contributes to sustainable development through tax incentives and reliefs.

i. R&D costs deduction

The Law on Corporate Income Tax (LCIT) provides an incentive in the form of the possibility of excluding 80% of qualified income from the tax base (consequently reducing monetary tax liability).

Qualified income is the income that a person/entity realizes as a holder of copyright or related rights based on the fee for the use of a deposited work of authorship or subject of related rights registered by depositing it in the register of the competent authority (LCIT refers therewith to the Law on Copyright and Related Rights as the organic regulation).

Qualified income is excluded by first reducing the income for tax-deductible expenses related to research and development activities that resulted in the creation of that work of authorship or subject of related rights (qualified expenses).

It is required to keep accurate records of all relevant income and expenses, and qualified income must be separately stated in the taxpayer's tax balance sheet.

This is often neglected by the rising startups and business undertakings but can be of crucial importance (apart being mandatory by LCIT) when one does strive towards efficient business paved with smart tax planning while not just seeking the "bail-out" from investors.

Moreover, keeping accurate records while complying with the law and tax planning shall transmit appropriate signal for AIF Company and other investors.

The right to use this incentive is not available when application for invention is rejected by the competent authority, and if the submitted application is rejected, used reductions must be withdrawn from the tax base (tax base correction) in the

respective tax period.

ii. Tax credit when investing in "newly incorporated companies conducting innovative activities"

Further, LCIT stipulates that a taxpayer which cannot be considered a "newly incorporated company which conducts innovative activities" (e.g. startups and other business ventures), and which invests in the capital of such newly founded company which conducts innovative activities, is granted the right to a tax credit in the amount of 30% of investment.

The maximum amount of the tax credit thereof is RSD 100,000,000.00, and regardless of the number of investments on account of company's income tax in one tax year, is RSD 50,000,000.00.

LCIT defines a newly incorporated company which conducts innovative activities as any company whose incorporation has not been more than 3 (three) years old, and which predominantly conducts innovative activities in the sense of the Law on Innovation Activities, i.e. undertakes activities for the creation of new products, technologies, processes and services or

significant changes to existing ones, in accordance with the market requirements, and which meets (cumulatively) the following conditions:

- annual income according to the latest financial reports does not exceed RSD 500,000,000.00;
- since its incorporation, it has not distributed dividends, i.e., profit shares, and will not distribute them for a period of three years from the date of investment;
- the center of business activities is located on the territory of the Republic of Serbia;
- did not result from a status change in accordance with the Company Law;
- in each tax period, starting from the first following period from the period representing the moment of incorporation and ending with the period when the full payment of monetary contributions was made:
 - research and development costs make up at least 15 percent of the total recognized expenses, or
 - highly qualified employees make up more than 80 percent of all employees, or
 - is the owner or the user of the deposited work of authorship or patent that

is directly related to the innovative activity it performs.

The taxpayer (i.e., investor in newly incorporated company for innovative business activities) can use the tax credit in the first tax period following the expiration of 3 (three) years from the investment.

The unused part of the tax credit can be transferred to the company's income tax account for future accounting periods, but not longer than five years.

Both R&D costs reduction and tax credit may be used and are usually intertwined when it comes to conditions and terms of exercising it.

Mechanisms of implementation, application, closer conditions of tax incentives and ways of exercising the right to tax credits, methods of excluding qualified income from the profit tax base and recognition of expenses related to R&D are regulated by secondary legal acts - rule-books.

It is obvious that, with the rapid development of the IT industry in Serbia, both in terms of the model and way of doing business and in terms of the profits that the industry brings (including the export potential of service providing), applicable legal solutions are also progressing as a necessary legal framework for investment, development and sale of IT products, services, and ecosystems as a whole.

The abovementioned is part of the legal regulation that has a positive impact on the IT sector. However, there are numerous issues that are not sufficiently clarified in practice and that have a significant financial and strategic impact on IT,

such as the participation of employees and members of the company's management body in the company's ownership structure, incentives for employees, bonuses, reserved own shares of the company and financial instruments - the right on acquiring shares in the company and similar.

The relevant applicable legal regulations in Serbia already provide a sufficient legal framework and basis for implementation, while its individual actors are waiting for a "safe" moment in order to keep pace with the rise of this industry.

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